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The Choice Between Unilateral and Multilateral Trade Liberalization Strategies

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Developing countries would gain far more from unilateral trade liberalization than from multilateral trade liberalization negotiated over many years. Industrial countries could increase both economic and political incentives for reform by granting credit when developing countries undertake unilateral trade liberalization.

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International Trade

Under plausible assumptions applied for Argentina, Nogués calculates that a strategy of unilateral trade liberalization in Argentina would produce significantly more in exports (net present value) than would similar liberalization negotiated multilaterally over a period of 15 years.

Waiting to negotiate multilaterally entails a true cost (loss of exports because of continued misallocation of resources) and an uncertain benefit (the market access a country expects to gain by waiting to negotiate a reciprocal reduction of trade barriers). Liberalizing unilaterally implies a fast increase of exports from improved resource allocation but could imply a loss from a lower degree of market access.

Generally, Nogués concludes, as long as the costs a country suffers from its barriers are higher than those from other countries' barriers, it pays that country to liberalize unilaterally.

Developing countries tend to have more protectionist trade policies than the industrial countries. To the extent that this is so, it probably doesn't pay for developing countries to wait to negotiate in the multilateral trade negotiations (MTNs) — because to the extent that concessions are balanced, developing countries are not likely to end up with liberal trade regimes.

Those conclusions are based on economic analysis, however, and developing countries are increasingly driven by politics — and only marginally by economics — to participate in the MTNs.

If industrial countries were to give developing countries credit for unilateral liberalization programs, both economics and politics would shift in favor of faster reform programs. If credit were given, negotiating in the MTN would *never* be preferable to unilateral trade liberalization.

The net present value of increased exports from unilateral trade liberalization in Argentina would increase from US$19 billion (if no credit were given) to US$33.4 billion (if credit were granted in increasing amounts for the first 15 years and remained constant thereafter). And the political excuse for not liberalizing unilaterally would suffer a major blow.

Waiting for multilateral negotiation of trade liberalization is certainly preferable to maintaining protection, however. Nogués estimates that the present value of forgone exports would be US$53 billion if the present degree of protection were to remain unchanged.

This paper is a product of the International Trade Division, International Economics Department. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Salome Torrijos, room S8-033, extension 33709 (20 pages with charts and tables).

The Choice Between Unilateral and Multilateral Trade Liberalization Strategy 1/

I. Introduction

This paper develops a framework for analyzing the economic costs and benefits of unilateral and multilateral trade liberalization strategies. The interest in this topic is sparked by the apparent dilemma faced by some developing countries in the ongoing Uruguay Round of multilateral trade negotiations (MTNs). An active participation in the MTNs implies that what developing countries have to bargain away is worth something there. If so, it might pay to delay the introduction of unilateral measures in the hope of securing increased access to foreign markets.

Deciding on the merits of unilateral and multilateral trade liberalization strategies should involve economic and political factors. This note will address the economics of this decision. Section II will present and discuss the conceptual framework. Section III will apply this framework to the case of Argentina. I estimate that under plausible assumptions, the net present value of higher exports under a unilateral trade liberalization strategy is US$23 billion higher than a similar liberalization negotiated multilaterally during a period of 15 years. Section IV will assess the extent to which the findings for Argentina can be generalized. This section also stresses the importance of the credit issue.

1/ I appreciate comments to a preliminary draft received from Bela Balassa, J. Michael Finger and Patrick Messerlin and research assistance from Ms. Azita Amjadi.

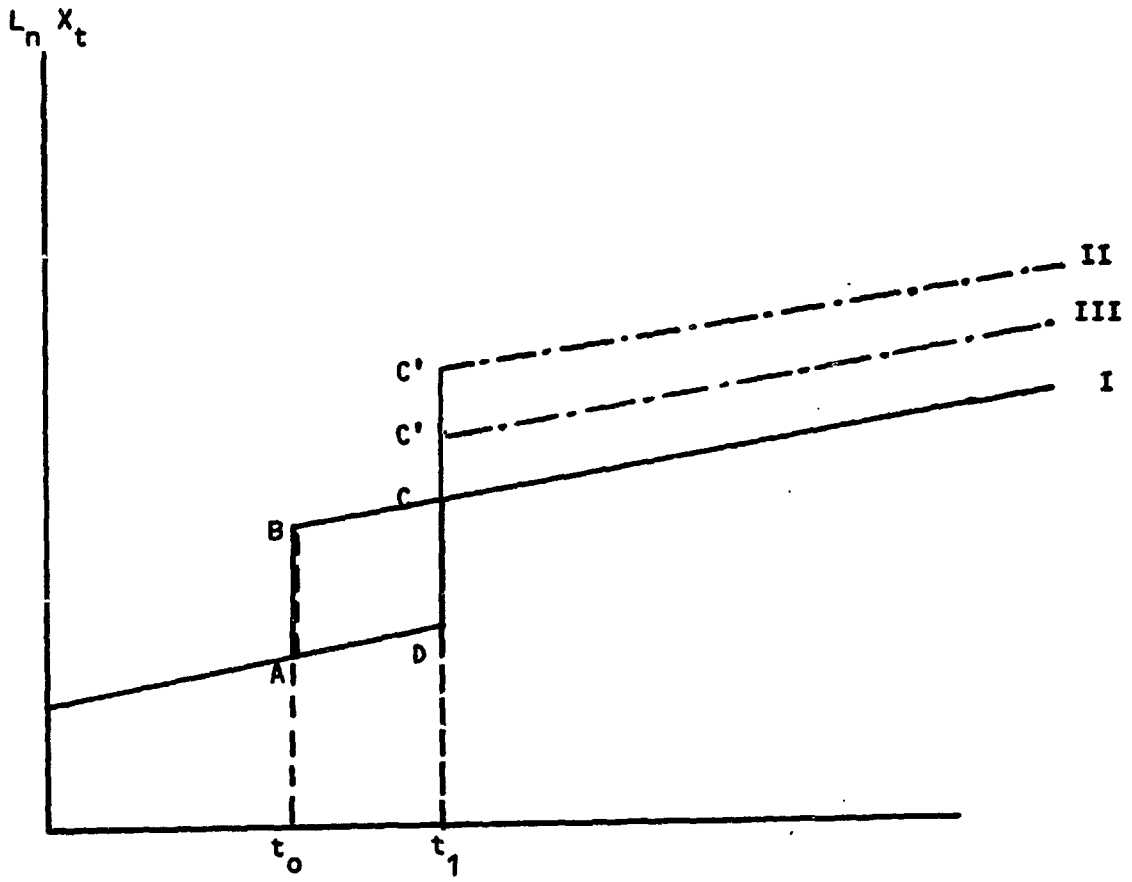
II. Conceptual Framework

Ideally, the benefits and costs of alternative trade policies should refer to resource allocation and their impact on GNP. Previous quantitative studies on the Argentine economy have focused on the export effects of alternative trade policies. Therefore, I will base the discussion on the impact of trade liberalization on this variable. Throughout I assume that liberalization does not affect the trade balance, i.e., changes in exports equal changes in imports.

Graph 1 depicts the two alternative trade liberalization strategies under consideration. At t_o a decision needs to be taken on whether to liberalize or wait until t_1 when the first among the future MTNs will be negotiated. Waiting entails a true cost and an uncertain benefit. The cost is given by the loss of exports (X) as a consequence of continued resource misallocation. This loss diminishes over time as the country bargains away its trade barriers. The uncertain benefit is the market access that a country expects to gain by waiting until t_1 and negotiating a reciprocal reduction of trade barriers. In the graph, I represent this by a shift of the time path of exports from C to C' i.e., from line I to line II. I assume that there are no dynamic gains from trade liberalization but only static resource allocation effects which result in a parallel upward shift of the export growth line.

Thus, the net economic return of an MTN liberalization strategy is given by the difference between the present value of ABCD--cost of delaying a unilateral trade liberalization--with the present value of the difference between C and C' from t_1 to infinity, i.e., the export benefit from the increased market access negotiated at t_1. Note that I have assumed that:

raph 1: TIME PATH OF EXPORTS UNDER UNILATERAL AND MULTILATERAL TRADE LIBERALIZATION STRATEGIES



I. Time path of exports under unilateral trade liberalization with no credit and no free ride.

II. Time path of exports under multilateral trade liberalization.

III. Time path of exports under unilateral trade liberalization with less-than full credit and/or free riding of the MTNs.

(a) the country will not free ride the MTN negotiated at t_1;

(b) that a unilateral trade liberalization at t_o receives no credit; and

(c) the trade liberalization implemented at t_1 is similar to the one that would have been implemented at t_o. It is also assumed that there are no policy reversals.

In regard to the first assumption, previous research has shown that although there has been some internalization of the trade gains negotiated by the active participants, the MTNs have provided spillover effects or free ride gains (Finger, 1976). Thus, assuming no spillover effects introduces a bias in favor of the multilateral trade liberalization strategy.

Likewise with the credit issue. If countries were to receive full credit for unilateral reduction of trade barriers, the economic gains from these actions would clearly be superior to those of multilateral actions. For example, in Graph 1, if other countries would provide credit for the unilateral trade liberalization program, exports could shift to say line III. Thus, the gains from unilateral trade liberalization strategy would include the PV of the difference between A and B from t_o to infinity plus the PV of the difference between line I and line III from t_o to infinity. Granting no credit for unilateral actions is tantamount to enticing developing countries to delay their liberalization. This is not in the interest of the multilateral trading system in general, nor of industrial countries in particular. Hence, the crucial importance of agreeing on the credit issue in the Uruguay Round.

The last assumption is controversial. The nature of the MTNs is to exchange trade concessions. Taken to its ultimate consequence, liberalizing in the MTNs implies that as long as a participant views that other trading

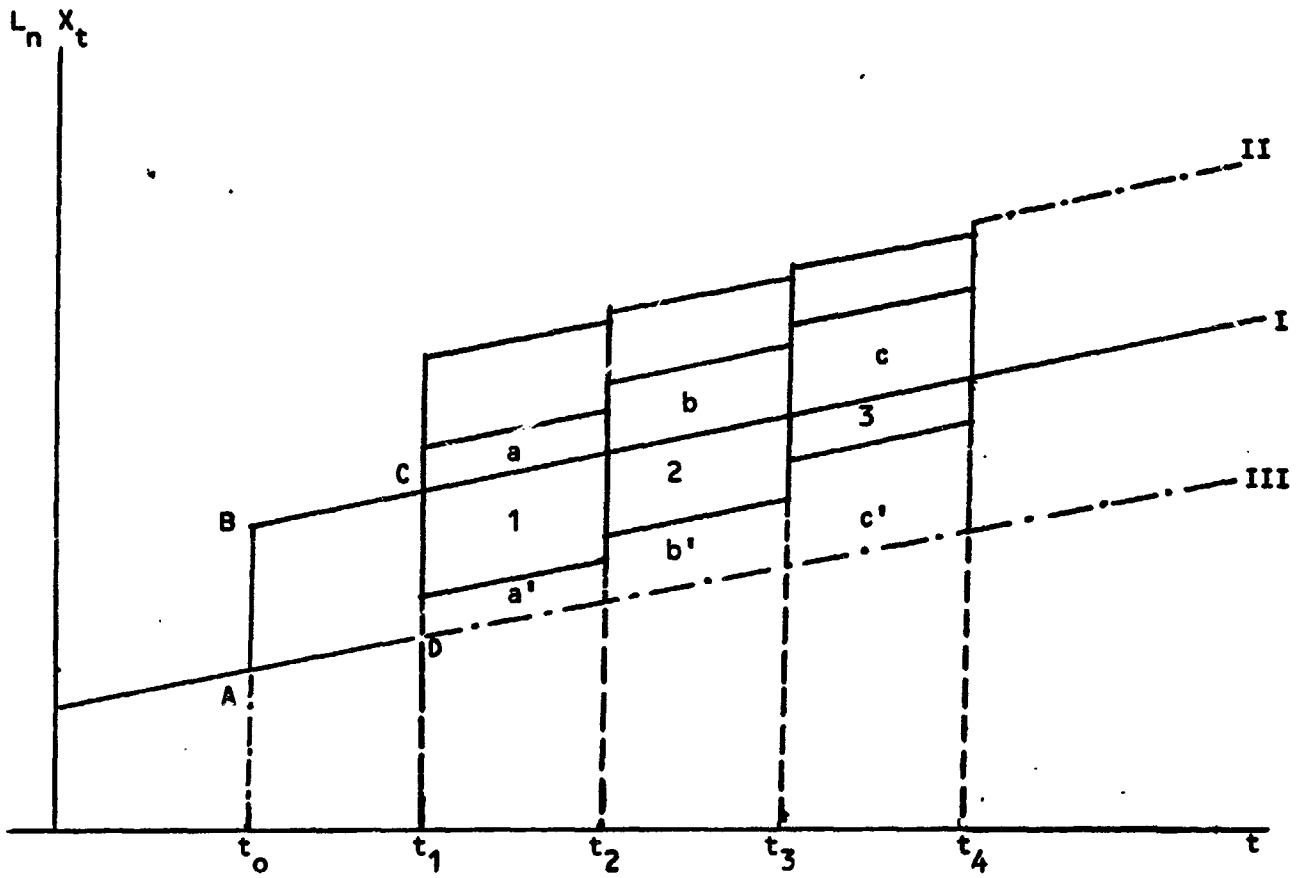
countries have some trade barriers, it will have an incentive to keep some in place in the hope that in the future, they could be negotiated away in exchange for greater market access.

In graph 1 this implies that if the liberalization that a country is considering at t_o is a shift to free trade, then this will take place at t_1 if, and only if, the concessions given by other countries are at least of equal value. There is no reason to expect that this balance of concessions will always exist. A country can be so protected that a shift to free trade will increase trade more than what other countries can offer in exchange if they would also shift to free trade. In this situation, seeking balanced concessions in the MTNs will not result in free trade. This appears to be the case in Argentina, which will be assessed in the next section.

Another consequence of following the MTN strategy is that unlike the case depicted in Graph 1, trade barriers will most likely be negotiated over several MTNs. This, for example, has been the experience of industrial countries (Bhagwati, 1988).

Graph 2 depicts this situation. Once again at t_o a decision needs to be taken between a unilateral liberalization or waiting to negotiate reductions of trade barriers in successive MTNs. The graph assumes that it takes four MTNs to achieve the same trade liberalization as the one considered to be implemented at t_o. Again, the benefit of negotiating in the MTNs has two components. The first is the increased market access gained by negotiating. This is represented by the sum of the rectangles a, b and c, and the difference between lines I and II for the periods extending from t_4 to infinity. The second component is the benefit to the country of removing its

Graph 2: TIME PATH OF EXPORTS UNDER UNILATERAL AND SEQUENTIAL MULTILATERAL TRADE LIBERALIZATION STRATEGY



I. Time path of exports under a unilateral trade liberalization strategy with no credit and no free ride.

II. Time path of exports under a sequential MTN liberalization strategy.

III. Time path of exports under no liberalization and no free ride.

own trade barriers. This is represented by the sum of a', b', c' and the difference between lines I and III from t_4 to infinity. The cost of an MTN liberalization strategy is given by the extended resource misallocation. In Graph 2 this is represented by the sum of ABCD plus rectangles 1, 2 and 3.

In contrast, the gains of unilateral trade liberalization with no free ride and no credit are given by the higher exports from improved resource allocation. In Graph 2, this gain is represented by the segment AB summed over the periods of time extending from t_0 to infinity. The costs are represented by the market access that would have been gained had the country waited and negotiated in the MTNs. In Graph 2, these costs are represented by the sum of the rectangles a, b, c and the difference between lines I and II for the periods extending from t_4 to infinity.

The above analysis has presented the simple economics of unilateral and multilateral trade liberalization strategies. The analysis could perhaps be made more realistic, for example, by introducing the notion of negotiating power and allowing for the formation of coalitions among countries. I don't believe, nevertheless, that these complications could alter the basic conclusion of this paper.

III. The Case of Argentina

This section will provide an estimate of the economic gains and costs of alternative trade liberalization strategies for Argentina. The previous discussion indicates that two types of information are necessary for undertaking this exercise. First, quantitative information is needed on the export gains associated with negotiated increases in access to other countries' markets and export gains associated with a unilateral trade liberalization policy. In the second place, a scenario for the MTNs needs to

be defined. Subsections 1 and 2 will discuss these issues, while subsection 3 will present and discuss the estimates.

1. Export gains

It was concluded from the previous analysis that the greater the costs from other country's trade barriers, the more likely it will be that the comparison will favor an MTN approach to trade liberalization. On the other hand, the longer it takes to liberalize in the MTNs and the easier it becomes to free ride them, the greater the likelihood that the analysis will favor a unilateral trade liberalization.

Argentina is one of the few countries for which the available data on the export effects of alternative trade strategies allows to construct an approximate estimate of net gains of liberalizing unilaterally and multilaterally.

In regard to the impact on Argentina's exports of other countries' trade policies, Zietz and Valdéz (1987) have estimated that if industrial countries removed their barriers to agricultural imports, exports of these goods would increase substantially. The estimates show that exports would increase by US$2,233 million for beef; US$208 million for wheat; and US$175 million for corn. Prices are in 1980 US dollars. In this study, Argentina is the country that would gain the most from industrial countries' removal of barriers to agricultural trade. As said, this favors the MTN liberalization strategy.

In regard to Argentina's non-food manufactured exports--which amount to around US$2.0 billion--around one third go to industrial countries, where they face few barriers (Laird and Nogués, 1989). Thus, these countries'

liberalization of manufactured import barriers would provide only marginal benefits to Argentina. 1/

Likewise, if other developing countries were to remove their trade barriers, Argentina would benefit only to a small extent. The greatest benefits would probably come from liberalization in other Latin American countries (LAC) and in particular Brazil. Nevertheless, even in these cases liberalization would provide relatively small export gains to Argentina in relation to liberalization of agricultural protection.

Given these considerations, it appears reasonable to assume that trade liberalization of other countries would increase Argentina's annual exports by an amount equivalent to US$3 billion of 1980 dollars.

Let me now turn to the export gains that Argentina could achieve if it were to remove its own trade barriers. Sturzenegger (1988) has estimated that under free trade policies, during 1980-85 Argentina would had increased its agricultural exports by significant amounts. In this study, estimates of export gains are provided for wheat, corn, sorghum, soybean, sunflower, and beef. For the period 1980-85, Sturzenegger estimates that if Argentina had been under a free trade regime, on average, annual exports--in current dollars--of these products would had been US$7.1 billion higher than what they actually were. In real 1980 prices, annual exports would had been US$8.3 billion higher.

Research has also shown that the efficient industries of Argentina's manufacturing sector would also benefit significantly from the removal of

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1/ Industrial countries' tariff escalation from raw materials to foodstuffs is probably the most serious barrier faced by manufactured food exports of Argentina in industrial countries. Unfortunately, no estimates of the trade gains of reducing this escalation are available.

trade barriers that re protecting several inefficient manufacturing industries (Nogués, 1985). Unfortunately, there are no measurement of the potential export gains of manufactured products from unilateral trade liberalization policies. Although it is more than likely that trade liberalization will increase Argentina's manufactured exports, I prefer to be conservative. I will therefore assume that the export gains are those indicated for agricultural products, i.e. US$8 billion per year.

2. The multilateral scenario

Having introduced the basic figures, let me now discuss a reasonable MTN scenario for making the economic estimates. Several issues must be decided including:

- the time span it will take for other countries to lower their trade barriers;
- the speed of the unilateral trade liberalization;
- the time span until resources are reallocated and efficiently used;
- the importance of short-run transitional costs;
- the extent of internalization in the MTNs;
- the multilateral formula for reducing trade barriers;
- the time elapsed until the first MTN negotiation takes place; and
- the rate of return for discounting future flows.

On the first question, it is known that the US and the Cairns group's proposal for dismantling agricultural trade barriers in ten years will not go through. I will assume that it will take 20 years. Simulations will also be provided for 15 years -- a rosy scenario which favors the MTN strategy. As said, I assume that other countries' trade barriers to manufactured trade are not all that important for Argentina.

In regard to the speed of the unilateral trade liberalization, I will assume that there is a sudden shift of policy. This is not a crucial assumption. What is important for the results is that the unilateral trade liberalization be implemented faster than the multilateral.

Even under a unilateral trade liberalization, I assume that there is a time span until resources are reallocated and efficiently used. There are two causes. The first is associated with the characteristics of the production processes of agricultural products where the lag between production decisions and the corresponding output flow is usually one year. Also, in the unilateral shift to free trade, it is unlikely that in only one year Argentina could reach a value of increased potential exports as high as forecasted, i.e., US$8 billion of 1980 dollars. I will assume that it takes four years to reach this potential. I will also assume that each of the years between the second and fifth after liberalization is introduced, exports increase by 25% of the potential or US$2.0 billion per year. I will assume that this later delay is not present in the MTN strategy because in this case, entrepreneurs know in advance the gradual policy shifts and adjust accordingly.

An ongoing debate in the literature refers to the social costs of trade liberalization. These short-run costs are incurred mainly when the resource reallocation process triggered by trade liberalization policies result in short-run unemployment of resources. New evidence on the experience with trade liberalization policies in developing countries suggests that these costs might not be as high as many people think. It has been found "...that even in the short run, liberalization does not lower production and does not inhibit economic growth; rather, it is clearly associated with faster growth. This is particularly true for episodes of strong liberalization

policies--precisely those instances in which, presumably, rigidities and lags in positive responses should have led to a temporary loss of production..." (Michaely, Choksi, and Papageorgiou, 1989).

The own experience of Argentina does not give much clue on this issue. Probably one of the worst trade liberalization policy packages of the post World War II years is the one implemented by Argentina--the only one it has implemented--during 1976-1981. This attempt failed not because of the trade policy component of this package, but because of the macroeconomic disequilibrium which implied among other things a record overvaluation of the domestic currency. Cavallo and Cottani (1989), Nogués (1986) and several other researchers have attributed the costs associated with this experiment to the macroeconomic effects of the program rather than to the trade liberalization implemented during these years. Therefore, in the empirical estimation, I have assumed that, except for the time lags mentioned above, there are no short-run social costs associated with temporary unemployed resources.

As said, in regard to the extent of internalization in the MTNs, Finger (1976) has shown that it has been high but not complete. In today's protectionist environment, it is more likely for internalization of concessions to increase. I will present two estimates. I will first assume that Argentina follows the mercantilistic approach tit for tat, i.e., that what it gives away is exactly equal to what it receives. A second estimate will assume that Argentina shifts to free trade even if other countries are not able to reciprocate fully. Therefore, in this later estimate Argentina gives more in trade concessions than what it receives from other countries.

Now something needs to be said on the negotiating formula for reducing trade barriers in the MTNs. In this regard, I will assume that the removal of trade barriers is such that increased exports from improved market access and improved resource allocation increases by the same amount every year.

The time elapsed until the first MTN removal of trade barriers is important. The closer this episode is to the moment when the decision is being judged, the greater the gains of participating in the MTNs. Given that negotiators in the Ururguay Round have agreed to continue discussing agricultural trade policies, but that barriers are expected to decline only by the end of the Round, I have assumed that from t_o it takes two years before the MTN liberalization program starts to work.

Finally, in regard to the discount rate, I have used a figure of 15%. The relatively high figure is justified by Argentina's debt situation.

3. The estimates

Table 1 shows the benefits to Argentina of following an MTN liberalization strategy. Under the assumption that Argentina shifts to free trade even if its trading partners are unable to grant concessions of equal value, the present value (PV) of increased exports are US$31.3 billion and US$25.6 billion in liberalizations implemented in 15 and 20 years, respectively.

In the case when Argentina seeks balanced concessions, the gains in terms of exports from resource allocation are equal to those of increased market access. In this case, the gains in liberalization implemented in 15 and 20 years are US$17.9 billion and US$14.4 billion, respectively.

The cost of liberalizing in the MTNs is given by the resource misallocation of keeping trade barriers for longer than they would have, had a unilateral liberalization strategy been followed. Assuming that Argentina removes all trade barriers, the PV of the costs of MTN participation are US$35.3 billion and US$38.8 billion for liberalizations implemented during 15 and 20 years, respectively. Thus, the costs in terms of forgone exports of a relatively slow negotiated removal of trade barriers are higher than the benefits and the net PV of a negotiated shift to free trade shown in Table 2 is negative.

In the case where Argentina seeks balanced concessions, it will reduce barriers up to the point where the value of increased imports is equal to those received from other countries; i.e., US$3 billion. This implies that Argentina will keep in place trade barriers which are costly. Thus, the net PV will be lower than that associated with a shift to free trade. In the case where Argentina grants concessions equivalent to US$3.0 billion per year (equal to those received from trading partners), the cost of resource misallocation in terms of foregone exports amounts to US$46.6 billion and US$47.9 billion for MTN's lasting 15 years and 20 years, respectively.

These results do not imply that an MTN liberalization strategy is not desirable. Any liberalization is superior to the status-quo of protection. If protection were to remain unchanged to eternity, the PV of forgone exports would amount to US$53 billion. This figure is quite higher than those presented in Table 2.

Table 1: PRESENT VALUE OF EXPORTS UNDER AN MTN LIBERALIZATION STRATEGY
(Millions of Dollars)

Source of Economic Gain	Years 15	20
A. Shift to Free Trade		
Resource Allocation	22,311	18,401
Market access	8,966	7,198
Total:	31,277	25,599
B. Balanced Concessions		
Resource allocation	8,966	7,198
Market access	8,966	7,198
Total:	17,932	14,396

Table 2: NET PRESENT VALUE OF INCREASED EXPORTS UNDER AN MTN LIBERALIZATION STRATEGY
(Millions of Dollars)

Extent of Liberalization	Years 15	20
Shift to free trade	-4.0	-9.7
Balanced concessions	-25.6	-32.0

Finally, the net present value of following a unilateral trade liberalization is equal to the difference between the benefit of improved resource allocation and costs of market access that would had been obtained had Argentina negotiated. Another cost mentioned above, is the time it takes

Argentina to fully reap the benefits of free trade policies. As indicated above, I have assumed that this lag is of five years. Under the assumptions, Table 3 shows that the net PV of a unilateral trade liberalization program is US$19.0 billion. This compares with a net PV of minus US$4.0 in a shift to free trade negotiated multilaterally during a period of 15 years. It also compares with the PV of maintaining the status-quo of minus US$53 billion.

Table 3: NET PRESENT VALUE OF A UNILATERAL TRADE LIBERALIZATION
(Millions of Dollars)

Source of Economic Gains and Costs	
Improved resource allocation	43,776
Loss of market access a/	7,198
Loss from lags in adjustment to a fully efficient economy	17,557
Total:	19,021

a/ Loss of market access in a 15-year MTN.

IV. Extensions and the Credit Issue

In deciding between a unilateral or a multilateral trade liberalization strategy, political and economic factors must be taken into account. This note has centered its analysis on the economics of this decision. The exercise is useful in that it points to some of the issues that must be considered when evaluating these alternative courses of actions.

The analysis has shown that an MTN liberalization strategy of

balanced concessions is more likely to be economically preferable to a unilateral strategy when:

- the costs to the country of other country' trade barriers are higher--in some cases significantly higher-- than the costs of its own trade barriers;
- the MTN will give no credit for unilateral actions;
- there is no free riding of the MTNs, or if there is, it will only be a small fraction of what the country would obtain under full participation in the MTNs.

For Argentina, I have argued that in spite of being one of the countries most seriously affected by other countries' barriers and in particular by industrial countries' agricultural policies , the net PV of a unilateral liberalization is significantly higher than that of a multilateral negotiated liberalization.

What about other developing countries? The general conclusion that stems from the analysis is that as long as the costs suffered by a country from its own trade barriers are higher than those suffered because of other countries' barriers, it still pays to liberalize unilaterally. In this regard, the structure of protection in industrial and developing countries show that in general the latter have more protectionist trade policies than the former (Laird and Nogués, 1989). Thus, to the extent that trade of developing countries takes place mainly with industrial countries, it would appear that it does not pay to negotiate in the MTNs; i.e., liberalization under relatively balanced concessions will unlikely result in liberal trade regimes for developing countries.

But the world is driven also by politics, which implies that even if developing countries were aware that the gains from unilateral trade

liberalization are far superior than those of an MTN strategy, many would perhaps still decide to wait and attempt to extract concessions in the MTNs. This is the strategy that industrial countries decided to follow after World War II, and it is also likely the strategy that an increasing number of developing countries might decide to follow as they familiarize themselves with the politics of the MTNs.

This is a cost for developing countries and for the trading system. Given that we must live wtih the MTNs, it is important to try to seek ways of reducing the costs entailed by them. In this sense, policies can be designed to help developing countries reach an agreement to liberalize faster than the pace dictated by the MTNs. Maximizing internalization of the MTNs and not providing credit for unilateral trade liberalization programs are signals taken by developing countries in favor of an MTN liberalization strategy.

If industrial countries were to give credit to developing countries for unilateral liberalization programs, the economics and politics would clearly shift in favor of faster reform programs. If credit were given, negotiating in the MTN would never be preferable to a unilateral trade liberalization strategy. In the case of Argentina presented in Table 3, the net PV of a unilateral trade liberalization would increase from US$19 billion in a situation of no credit, to US$33.4 billion in a situation where credit granted is increasing during the first 15 years and thereafter remains constant.

Likewise, the political excuse for not liberalizing unilaterally would suffer a major blow. International pressures as well as the interest of domestic exporters would shift in favor of fast reform programs. Such actions from developing countries would improve their economic prospects and enhance

the international trading system. Thus the urgency of deciding on the credit issue.

V. Summary and Conclusions

This paper has developed a simple framework for analyzing the economic costs and benefits of unilateral and multilateral trade liberalization strategies. Applying the framework to Argentina, I estimate that the difference in terms of exports between the net present value of a unilateral and a 15-year MTN liberalization to free trade is US$23 billion in favor of the first.

The structure of protection between countries suggests that only few developing countries would gain by waiting to bargain their trade restrictions in the MTNs instead of implementing a unilateral trade liberalization program. This presumption stems from the fact that an important part of exports from developing countries go to industrial countries and as a general rule, the first group of countries are more protected than the second group.

The analysis could be complicated in many ways, but it is unlikely that the basic conclusion--that unilateral trade liberalization actions provide significant more economic gains than a similar liberalization negotiated multilaterally over many years--could be altered.

We do not see significant unilateral trade liberalization actions taken by many developing countries. This might be in part due to the fact that they are increasingly driven by politics and only marginally by economics to participate in the MTNs. Because of this, I have argued that if industrial countries were to grant credit for unilateral trade liberalization actions implemented by developingy countries, both the economics and politics would shift in favor of these programs.

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